FOMC BRIEFING
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LONG-RUN TARGETS

The period since the last FOMC meeting has been marked by weakness in the aggregates -- especially M1 and M2. For the first half as a whole, all the aggregates have decelerated sharply from last year and the broad aggregates are running at rates below those anticipated by the Committee at its February meeting. At that time, expectations were for growth in M2 and M3 around the middle of their new ranges, assuming, however, that there were no major changes in interest rates. In June M3 was around the lower end of its range and M2 well below its range, while M1 had expanded at about half last year's pace. Clearly, this experience raises questions about the kind of growth in the monetary aggregates that would be compatible with acceptable performance of the economy and inflation -- and in particular whether the current range for M2 for 1987 is likely to encompass such growth.

Three general points concerning developments in the first half of the year seem relevant. First, the slowing of money growth this year does not appear to signal a concurrent weakening of growth in nominal income; nominal GNP in the first half of the year is estimated to have expanded above the pace of last year, and is projected to continue to do so in coming quarters as well. Second, some special factors, perhaps related to tax reform, may have been at work in the deceleration of M2, which is more than would be predicted by available models of money demand. Also there were some unusual funding patterns that probably affected M3. The staff has implicitly embodied in its forecast of money growth rates given in this bluebook a tapering off or reversal of some of these effects. However, for M2 they are not thought to be very large, and we don't anticipate a spontaneous resurgence of M2 growth of sizable proportions.

Third, the available evidence does suggest that a substantial portion of the slowing in money growth can be ascribed to the relative movements of market and deposit interest rates, which raised opportunity costs of holding money, after several years of decline. The increase in opportunity costs has been particularly marked for M1, where the rise has been accentuated by the steeper yield curve and faster adjustment of time deposit rates. This has had a large impact on NOW accounts, given their use as a saving vehicle, but demand deposits also have weakened very substantially, including a large decline in June. The reasons for this are not entirely clear, but these deposits seem to have become increasingly sensitive to interest rate movements in recent years, perhaps as the proportion linked to compensatory balance arrangements has risen. This weakness in demand deposits probably is showing through to M2, since it is less likely than with NOW accounts to involve a shifting into other M2 assets. The sluggishness of offering rates or other very liquid components of M2 -- such as savings accounts and MMDAs -- also is thought to be contributing to the apparent interest sensitivity of this aggregate over the short- and intermediate-runs.

This interest sensitivity is important in considering the alternatives for 1987 and 1988. In the staff forecast the slower money growth to date is not seen as impairing the outlook for the economy. Implicitly, the rise in nominal rates that has occurred is not thought to have resulted in levels of real rates that would unduly damp domestic demand -- indeed a case can be made that real rates are not at historically high levels given the worsening of inflation expectations earlier this year. And, the decline in the exchange rate to date is expected to work toward further improvement of our external imbalance, though as Mr. Truman has indicated, further depreciation of the dollar is assumed to be necessary at some point to sustain such progress. The downward movement of the dollar puts upward pressure on prices, especially given a projected robust expansion of net exports that keeps the unemployment rate in the neighborhood of the natural rate. In this environment nominal interest rates are expected to rise further, both in reflection of persisting price pressures and as policy makers act to restrain the inflation process. The upward movement in nominal rates in turn damps money demand and is reflected in rising velocity.

A set of charts distributed this morning shows the projected movements in velocity implied by the interaction of interest rates, income growth and monetary expansion in the staff forecast. As can be seen in chart one, the increase in M2 velocity begun in the first half of 1987 is projected to continue through 1988. M2 is expected to increase at a little over a 5 percent rate for the balance of the year, as the depressing effects of some special factors and recent declines in demand deposits and the managed liability-linked components abates. Growth for 1987 would be between 4-1/2 and 5 percent -- below the lower end of its current range -- and at a similar rate in 1988, about 1-1/2 percent below the growth in nominal GNP over the two years. In effect, the pickup in inflation and interest rates works to reverse a portion -- though by no means all -- of the velocity declines of recent years associated with the disinflationary process. Expansion of M3 is expected to rebound to a bit over 7 percent in the second half of this year, reflecting primarily a shift in funding patterns at banks toward elements in this aggregate.

Such growth would place this aggregate well up into its current range -- growth of about 6-1/2 percent is anticipated for this year and next. The velocity of this aggregate would remain essentially unchanged over the two years, in contrast to its long-term downtrend.

The next chart shows the velocities of M1 and M1A. Demand deposits are projected to resume growing during the third quarter, but with opportunity costs of both demand and NOW accounts rising, growth of M1 and M1A would be quite damped -- on the order of 3 to 4 percent for both aggregates over the next 6 quarters -- and their velocities would increase. The recent focus on M1A in some circles seems to be keyed in part to the persistence of the trend increase in its velocity past the time when M1's velocity turned down. The jump in M1A's velocity in 1981 was associated with the advent of NOW accounts. Its subsequent smooth trend until early 1985 is thought to have been largely a product of two offsetting effects: continued shifts out of demand deposits as deregulation proceeded and the support for demand deposits arising from declines in interest rates. The trend was broken in 1985 once the shifting had tapered off, allowing the underlying declines in velocity associated with interest rate developments to emerge. The projected return to the trend rate of velocity growth this year and next depends on the assumed rise in rates.

Debt velocities are shown in the next chart. The staff projects debt growth of around 9-1/4 percent this year and 8-3/4 percent next, still in excess of income growth, but by smaller margins than in recent years.

In sum, if the staff's assessment of the forces at work is about right, money growth would need to accelerate from its very recent sluggish pace to maintain moderate income growth, but restraint on inflationary forces may require slower growth in M2 in 1987 than now allowed by its present range. The current ranges, along with the bluebook alternatives for 1987 and 1988 are shown for reference on the table on the next page. Hitting the lower end of the current M2 range would require a substantial acceleration of this aggregate over coming months. An acceleration of this magnitude proably would require that interest rates at least not increase noticeably over the second half of the year. Stable or even declining rates may come about should underlying demands on the economy or inflation pressures turn out weaker than the staff or perhaps even the market expects, or should the dollar remain firm. But if these conditions do not prevail the current range could come into conflict with policy options that seemed consistent with other emerging developments.

Alternative II would involve a full percentage point reduction in the M2 range, while retaining the current ranges for M3 and debt. The lower M2 range would give some room for a firming of policy, though probably not very much. Even the lower end of this range requires a considerable pickup in M2 growth from recent experience, and its adoption would imply that the Committee did not expect these very recent growth rates to continue. Another option might be to retain the current range but announce that growth could fall short should inflation pressures and other conditions seem to call for it. This could be seen as in effect further deemphasizing money targets, however.

The issues for 1988 are similar to those for 1987. The 5-1/2 percent lower end of the current range -- given as alternative I -- would seem to offer only a little room for a further increase in velocity should that tend to emerge from the price and financial conditions accompanying an acceptable outcome for the economy and prices. If there were considered to be strong inflationary risks, some reduction in the ranges might be considered approprate. Even in the absence of such risks, lower ranges could be seen as another step in implementing the Federal Reserve's announced intention to move over time to rates of money and credit growth consistent with price stability. Alternatives II and III are two possible approaches. In these alternatives the reductions of the M2 ranges are larger than for the M3 ranges in recognition of the greater interest sensitivity of the former. A higher range for M3 than for M2 is not unprecedented, and is consistent with differences in the behavior of the velocity of these two aggregates over the long run. The alternative II range for M2 is the same as the alternative II range for 1987 for this aggregate, but this alternative would embody lower ranges for M3 and debt. However, the lower end of the alternative II range for M2 is not much below the staff's expectation for growth in this aggregate next year, given the presumed increases in interest rates. The alternative III range for M2 is more nearly centered on the staff forecast, allowing room for slower growth should that be appropriate. The midpoint of the range, at 5 to 5-1/2 percent is a little above where M2 is projected to come out this year. The upper limit of the alternative III range has been lowered only to 7 percent, to accommodate faster growth and possible further declines in velocity should the economy or inflation turn out on the weak side. Any of the alternatives would be consistent with the staff's projection of debt growth of around 8-3/4 percent next year, although alternatives II and III would allow more room for a shortfall from this projection and the possibility that debt would again expand more in line with income.

With respect to M1, while the staff is projecting a return to an uptrend in velocity, as pointed out before, this is highly dependent on the assumed rise in interest rates. This aggregate appears to remain extraordinarily sensitive to interest rate changes, as indicated by the swing from a 9 percent velocity decline last year to essentially no change in the second quarter. In the model results M1 is from two to three times as interest elastic as M2 over a 4-quarter span. Moreover we are still gaining experience with the behavior of savers and depository institutions in a deregulated environment. Under these circumstances, an M1 range consistent with the M2 range in allowing for various contingent outcomes for the economy in interest rates would have to be extraordinarily wide -- perhaps 6 percentage points or more.